

## **ASSOCIATION BETWEEN CORPORATE GOVERNANCE AND RELATED PARTY TRANSACTIONS: A CASE STUDY OF BANKING SECTOR OF BANGLADESH**

Mohammad Zakir Hossain Sharkar  
*BRAC Business School  
BRAC University, 66 Mohakhali C/A  
Dhaka – 1212, Bangladesh*

and

Md. Abdus Sobhan  
*Department of Accounting & Information Systems  
University of Dhaka  
Dhaka-1000, Bangladesh*

and

Shahida Sultana  
*School of Business Studies  
Southeast University, 64/B, Banani  
Dhaka-1213, Bangladesh*

### **ABSTRACT**

This paper critically examines the relationship between corporate governance and related party transactions (RPTs). RPTs have become a global hot topic due to the link between undisclosed RPTs and the collapse of some high profile companies. This paper analyses the current literature and establishes a relationship between corporate governance indicators and the number of RPTs by using Bangladesh banking sector data.

**Key words:** Corporate governance, Related Party Transactions, Bangladesh Banking Sector.

### **I. INTRODUCTION**

The use of undisclosed related party transactions (RPTs)<sup>1</sup> can facilitate fraudulent financial reporting and misappropriation of assets. The recent failure of giant corporations in the USA again confirmed this. For example, Enron used special purpose entities controlled by its CFO to manipulate income and transfer cash, and Adelphia guaranteed related party debt and provided extensive loans to its executive (Kohlbeck and Mayhew 2004) [1]. As

a result, Congress passed section 402 of the Sarbanes Oxley Act, which banned most loans to executives and directors. This act has become controversial because RPTs are not always harmful for the performance of the company. Sometimes it becomes inevitable for the company to enter into RPTs to maximize the benefits to the shareholders. So an alternative view is that strengthening corporate governance<sup>2</sup> -rational payment to the

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<sup>1</sup> "Related party transactions include transactions between (a) a parent company and its subsidiaries; (b) subsidiaries of a common parent; (c) an enterprise and trusts for the benefit of employees, such as pension and profit sharing trusts that are managed by or under the trusteeship of the enterprise's management; (d) an enterprise and its principal owners, management and the members of their immediate families; and (e) affiliates" (FASB 57, 1982).

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<sup>2</sup> "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."-UTS centre for corporate governance, University of Technology Sydney

member of board and the appointment of outsider monitors- can help in justifying RPTs (Gordon, Henry and Palia 2004) [2].

## II. AIM AND SCOPE

The aim of this study is to discuss the relationship between RPTs and corporate governance in developing countries. The developing countries have been selected as a research area because almost all the study conducted so far related to this issue has been in the context of the USA and other developed countries (Gordon et al 2004b) [2], (Kohlbeck and Mayhew 2004) [1]).

The scope of the study is limited to analysis of the association of RPTs and governance in banking sector of Bangladesh. The banking sector of Bangladesh is selected because banks are the lender of depositors' money and failure of banks can result in direct monetary loss to depositors. Due to privatization, most of the shares of a bank are owned by professional businesspeople who have other businesses. These people hold the Board of Directors' position due to their major ownership and use the banks' resources for personal benefits. But little research has been conducted in Bangladesh regarding the need for controlling and improvement of disclosures of RPTs.

## III. STRUCTURE

The next section of this paper presents an analysis of the related laws and pronouncements as well as current literature on related party transactions for banks. The last section of this paper deals with analysis of the findings.

## IV. LITERATURE REVIEW

### A. History and Context

The history of RPTs can be traced as back as to the emergence of corporate type of business after industrial revolution. It first came into focus in 1973 when U.S. Financial Corporation used it to create millions of dollars phantom profits and blew up its per share earnings and price and consequent bankruptcy of the company (PCAOB, 2004) [3].

Financial Accounting Standard Board (FASB) issued Statement of Financial Accounting Standard no. 57. FASB (1982, 1) [4] statement 57 describes RPTs as one of the important areas involving high

fraud risk. American Institute of Certified Public Accountants (AICPA, 2001) [5] also describes RPTs as a mechanism used by major shareholders and management to overstate income and provide inaccurate financial results to market participants. It is now mandatory for a company to disclose all material RPTs including the nature of the relationship, a description of the transaction, the dollar amount of transaction for each income statement period presented, the amount due to and due from the related parties at balance sheet date; but disclosure is not required when the transactions are eliminated in consolidation (FASB 1982, 1) [4]. Though Securities and Exchange Commission, USA (SEC- USA) relies on Generally Accepted Accounting Principles (i.e., FASB 57) it requires disclosure of any RPTs involving a dollar amount exceeding \$120,000 and in which the related party has direct or indirect material interest, naming such person and indicating the relationship to the company, the nature of such person's interest in the transaction, the amount of such transaction, and where applicable, the amount of such person's interest in the transaction (SEC 2004, subsection 229.400) [6]. Both SEC rules and FASB requires disclosure of RPTs but they differ in terms of place of disclosure. FASB requires disclosure of RPT in financial statements but SEC rules do not specify the place of disclosure in the financial statements. This disclosure requirement differs from country to country but almost all countries through out the world used FASB Statement 57 as a basic guideline.

### B. Current Theory and Debate

The issues of RPTs again became a hot topic after the recent high profile corporate fraud in the USA involving RPTs and consequent debarred of loans to directors and executives by US congress without any discussion with professionals. The academic community disagreed with the above regulation of congress because RPTs is not always detrimental to the best interest of the shareholders. There is a common belief among market participants that RPTs is always against the best interest of the common shareholders because it is assumed that through RPTs the member of the board uses the resources of the company for their personal benefit. For example, the CEO of a bank takes loan from the organization at a lower interest rate than the market. This view of RPTs is consistent with 'potential wealth transfer' of FASB 57, 'conflict of interest hypothesis' of Gordon et al and 'agency

concern' considered by Berle and Means (1932) [7] and Jensen and Meckling (1976) [8]. The opposing viewpoint regarding RPT is that company can enter into RPT to maximize the interest of the shareholders. It occurs when substance of the transaction justify the underlying economic reality. For example, a garments manufacturing company can invest in textile industry to get fabrics at lower price and increase overall profit. Gordon et al. (2004) [2] and Kohlbeck and Mayhew (2004) [1] supported this view as efficient contracting. So RPT itself is not always harmful for the shareholders. The important thing is the type of RPTs. So instead of regulation, the member of the board should justify that the transaction is based on its economic substance. This justification becomes weak when the organization is under weak corporate governance.

## V. METHODOLOGY

Both Gordon et al (2004a) [2] and Kohlbeck and Mayhew (2004) [1] conclude that weak corporate governance leads to more RPTs and find no justifications for the latest amendment of SEC Act by the congress. The different aspects of corporate governance environment includes cash compensation paid to the CEO and directors, percentage of shareholdings by CEO and directors, board size, duality of CEO / chair, percentage of shareholdings by institutional owners, percentage of independent directors in the board, number of board meeting, qualification of audit committee, percentage of independent members on the audit committee, number of audit committee meetings and control variable includes firm size measured by assets, EBIT and market value of equity. To test the relationship between weak governance and RPTs in developing countries the corporate mechanism test model by Gordon et al. is used with some modifications due to unavailability of some information and data was gathered principally from the banks' annual reports that are published annually. The final model for corporate governance test is as follows:

$$RPTs = \alpha_0 + \beta_1 CEO\ cash\ pay + \beta_2 CEO\ equity + \beta_3 \#BOD + \beta_4 Dual + \beta_5 DirFees + \beta_6 DirStock + \beta_7 InstOwner + \beta_8 DirInd + \beta_9 NBODM + \beta_{10} QAC + \beta_{11} ACInd + \beta_{12} NACM + \gamma_1 Assets + \gamma_2 EBIT + \gamma_3 MVE + \varepsilon$$

Here,

<i>RPT</i>	=	Number of related party transactions.
<i>CEO cash pay</i>	=	Total annual cash compensation to CEO.
<i>CEO equity</i>	=	Deciles ranking of the percentage of the shares held by CEO.
<i>#BOD</i>	=	Number of member in the Board of Directors.
<i>Dual</i>	=	An indicator variable equal to 1 if chairman is not an executive in the bank, and 0 otherwise.
<i>DirFees</i>	=	Annual cash fees provided to non-executive directors
<i>DirStock</i>	=	Deciles ranking of the percentage of shares held by directors.
<i>Inst owners</i>	=	Deciles ranking of the percentage of shares held by institutional investors.
<i>DirInd</i>	=	Percentage of independent directors on the board.
<i>NBODM</i>	=	Number of board meeting during the year
<i>QAC</i>	=	Average qualification of the audit committee members.
<i>ACInd</i>	=	Percentage of the independent directors in the audit committee.
<i>NACM</i>	=	Number of audit committee meeting.
<i>Assets</i>	=	Year-end total assets.
<i>EBIT</i>	=	Earnings before interest and taxes.
<i>MVE</i>	=	Year-end market value of equity.

A detail description of the variable is provided on appendix A

*CEO cash pay* and *CEO equity* are indicators of CEO compensation. Negative coefficient of these variables implies that low compensation leads to more RPTs. So, RPTs results from efficient contracting. *# BOD* and *Dual* are indicators of weak governance. Positive coefficients of these variables would imply association between weak governance and RPTs. *Dirfees* and *Dirstock* would have the same implication as CEO compensation. *Instowners*, *DirInd*, *NBOD*, *QAC*, *ACInd* and *NACM* are monitoring variable. So, negative

coefficients would be expected. Other variables are control variables. As all these control variables relate to firm size, positive association is expected.

## VI. CASE STUDY

### A. Context of the Case Study

The private banking sector in Bangladesh is an emerging sector. This sector is getting increasing attention due to its importance. It plays a vital role for development and growth of the economy through mobilizations of resources. A bank does business with the help of public funds, *i.e.*, deposits mainly and the failure of banks could result in monetary loss to depositors. The interest of depositors is even more important than shareholders of a general business organization. So establishing transparency and accountability in the banking institution is a crucial issue. The journey of domestic private banks starts in late 1980s with the establishment of International finance and investment Corporation Bank. Since then the number of private domestic banks increases rapidly. At present Bangladesh have 32 scheduled domestic private banks.

### B. Current Practice

All these scheduled banks are regulated by Bangladesh Bank, the central bank of Bangladesh. Bangladesh Bank is a regulatory body, which issues rules and regulations that need to be followed by scheduled bank to conduct banking business. According to Banking Regulation and Policy Department (BRPD) Circular No. 14 (2003) [9], related party is defined as a party, which can control or significantly influence the bank directly or indirectly. This significant influence can results from representation on board of directors, involvement in the decision-making process, material inter-company transactions, inter-change of managerial personnel, dependence on technical information etc. The spouse, parents, children, and dependants of the directors would generally be included in the related party. The bank should disclose the name of the directors and their affiliated organizations, all important contracts between the bank, its subsidiary or fellow subsidiary and directors' affiliated organizations, share options given to directors and executives; the nature, type, amount, changes in the amount, lending policy and the element of transactions.

The Bank Company Act 1991, section 27 specifically states that no banking company shall make any loans or advances on the security of its own shares and without security make any loan or advance to any of its directors; any member of the family of any of its directors; any commercial institution or private company in which the banking company itself, or of its directors or any member of the family of any of its directors is involved as director, owner or shareholder; any public limited company which is in some way or other controlled by the company itself, or any of its directors or any member of the family of any of its directors, or the shares of which are held by any of the said persons to such an extent as to give it control of no less than twenty percent of the voting rights of the following persons or institutions, or in case where those persons or institutions are guarantors. In addition to that no banking company shall give to any loan or advance without the approval of the majority of the director to any of its directors or any person, commercial institution or company in which any of the directors of the said banking company is interested as partner, director or guarantor. Moreover, no banking company shall, without the previous permission in writing of the Bangladesh Bank, give to any person or institution, directly or indirectly, any benefit the aggregate value of which exceeds 15 percent of the total capital of the said banking company; or 25 percent of the total capital of the said banking company where the security of the said benefits has been provided by such financial securities as might be easily put on the market for sale. In addition to that every banking company shall, before the close of the month to which the report relates, submit to the Bangladesh Bank a report in the prescribed form and manner about all loans and advances granted by it to companies, private as well as public, in which the banking company or any of its directors is interested as director or managing agent or guarantor. If no examination of any report submitted it appears to the Bangladesh Bank that any loans or advances have been granted to the detriment of the interests of the depositors of the banking company.

The section 28 of the Bank Company Act covers restrictions on the respite of loans. It covers that no banking company shall, without the previous approval of the Bangladesh Bank, grant respite of loans taken from it by any of its directors, or his family members; a commercial institution or company in which any director of the banking

company is interested as landowner, co-director, managing agent; and any such person in which any director of the banking company is interested as partner or landowner.

### C. Gaps in Current Theory and Actual Practice

Security Exchange Commission Rules of Bangladesh contain very few guidelines on disclosure of related party disclosure. Due to this, banking organizations in collaboration with auditors provides inadequate disclosure on RPTs. The World Bank (2003) [10] report on the observance of standard and codes states that though the ownership structure of many companies implies the existence of RPTs, disclosure in the financial statements is not as much detail as required by International Accounting Standard 24. Same results were found by Ahmad and Yousuf (2005) [11] in a study of corporate governance. According to them, inadequate disclosure is one of the most important obstacles to ensure good corporate governance. As a result, the banking sector is not free from financial abuses and crime. For example, currently The Oriental Bank Limited is going to bank craft after revealing the financial abuse of the ex-managing director who embezzled TK 595 core (The Daily Star, 2007). So the problem lies in the weak governance of the bank company, which gives the opportunity of illegal RPTs.

## VII. DISCUSSION AND CONCLUSION

Appendix B provides the results of association between the number of RPTs and corporate governance indicators. As shown in the appendix B, *CEO cash pay*, *# BOD*, *DirFees*, *Instowners*, *NBODM*, *ACInd*, *NACM*, and *MVE* are negatively and *DirStock*, *DirInd*, *QAC*, firm size measured by *Assets* and *EBIT* are positively associated with number of RPTs. These negative coefficients of *CEO cash pay*, *DirFees*, *Instowners*, *NBODM*, *ACInd*, *NACM* and positive coefficients of *DirStock* and size of the firms as measured by the *Assets* and *EBIT* is almost consistent with expectation and results of previous studies (Gordon et al, 2004) [2]. However, the negative coefficients of *#BOD*, *NBODM* and *MVE* and positive coefficients of *DirInd*, and *QAC* seems to be against the previous studies (Gordon et al 2004b) [2], (Kohlbeck and Mayhew 2004) [1]). In respect of significance level, *ACInd* is the most significant in controlling number of RPTs and *Assets* and *DirInd* are moderately significant in increasing

number of RPTs. *DirInd* should decrease the RPTs but the results shows reverse. It seems that the reported RPTs are not the appropriate number because of window dressing of the financial statements by the company in collaboration of auditors. So, fraudulent reporting cannot be prevented unless the governance mechanisms become strong.

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## APPENDIX A

### DESCRIPTION OF VARIABLES

VARIABLE NAME	VARIABLE DEFINITION
<i>RPT</i>	Number of related party transactions reported by individual bank
<i>CEO cash pay</i>	Cash compensation paid to chief executive officers as salary, bonus and other annual cash
<i>CEO Equity</i>	Deciles ranking of the percentage of the shares held by CEO to be measured by shares held by CEO divided by total outstanding shares multiplied by 10. This variable always equals zero because no CEO in the banking sector has shareholdings.
<i># BOD</i>	Number of member in the Board of Directors as shown in annual report
<i>Dual</i>	An indicator variable equal to 1 if chairman is not an executive in the bank, and 0 otherwise. This variable always equals 1 due to separation of CEO and chair in every bank under study.
<i>DirFees</i>	Annual cash fees provided to nonexecutive directors
<i>DirStock</i>	Deciles ranking of the percentage of shares held by directors measured by shares held by the directors divided by total outstanding shares multiplied by 10.
<i>Inst owners</i>	Deciles ranking of the percentage of shares held by institutional investors measured by shares held by institutional investors divided by total outstanding shares multiplied by 10.
<i>DirInd</i>	Percentage of independent directors on the board of directors. Independent director is defined as director having less than 5 percent shareholding.
<i>NBODM</i>	Number of meeting of board of directors during the year
<i>QAC</i>	Average qualification of the audit committee members. Qualification of individual audit committee member is equal to 5 if he or she has a professional business degree, it is equal to 4 if the member is a postgraduate in business, equal to three if he or she has any other postgraduate degree except business, equal to two if he or she has bachelor in business and equal to 1 for any other bachelor degree.
<i>ACInd</i>	Percentage of the independent directors in the audit committee
<i>NACM</i>	<i>NACM</i> Number of audit committee meeting
<i>Assets</i>	Fiscal year end total assets as shown on balance sheet
<i>EBIT</i>	Earnings before interest and taxes
<i>MVE</i>	Year end market value of equity as calculated by multiplication of year end market value of each share and total number of outstanding shares

# APPENDIX B

## REGRESSION RESULTS:

### Coefficients <sup>a</sup>

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	2.677	2.070		1.293	.252
CEOCASH	-2.198E-07	.000	-.141	-.617	.564
BOD	-.087	.051	-.408	-1.696	.151
DIRFEES	-4.023E-07	.000	-.419	-1.057	.339
DIRSTOCK	.037	.214	.056	.174	.869
INSOWNER	-.500	.344	-.323	-1.453	.206
DIRIND	.025	.009	.597	2.718	.042
NBODM	-.015	.017	-.146	-.905	.407
QAC	.824	.645	.547	1.276	.258
ACIND	-.052	.010	-1.178	-5.166	.004
ACMEET	-.117	.061	-1.225	-1.920	.113
ASSETS	1.110E-10	.000	1.473	2.840	.036
NOI	6.825E-10	.000	.266	1.402	.220
MVE	-1.677E-11	.000	-.141	-.524	.623

<sup>a</sup> Dependent Variable: RPTS